

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

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In the Matter of:

THE APPLICATION OF WILLOW CREEK)	
UTILITIES, INC., D/B/A WILLOW)	
CREEK SEWER SYSTEM FOR AN ADJUST-)	
MENT OF RATES PURSUANT TO THE)	CASE NO. 9099
ALTERNATIVE RATE ADJUSTMENT PRO-)	
CEDURE FOR SMALL UTILITIES)	

O R D E R

On July 13, 1984, Willow Utilities, Inc., d/b/a Willow Creek Sewer System ("Willow Creek"), filed an application with the Commission to increase its rates pursuant to 807 KAR 5:076, Alternative Rate Adjustment Procedure for Small Utilities ("ARF"). The proposed rates would produce additional revenue of approximately \$7,317 annually, an increase of 18.9 percent. Based on the determination herein, no deficiency exists in the revenues of Willow Creek and, therefore, no increase in revenues has been allowed.

A hearing was not requested in this matter and, in accordance with the provisions of the ARF, no hearing was conducted. The decision of the Commission is based on information contained in the application, written submissions, annual reports and other documents on file in the Commission's offices.

The Consumer Protection Division in the Office of the Attorney General ("AG") intervened in this case.

COMMENTARY

Willow Creek is a privately owned sewage treatment system organized and existing under the laws of the Commonwealth of Kentucky and serves approximately 320 customers in Oldham County, Kentucky.

TEST PERIOD

Willow Creek has proposed and the Commission has accepted the 12-month period ending December 31, 1983, as the test period for determining the reasonableness of the proposed rates. In utilizing the historical test period, the Commission has given full consideration to known and measurable changes found reasonable.

REVENUES AND EXPENSES

The ARF was established to provide a simplified and less expensive method for small utilities to apply for rate increases with the Commission. The financial data from the 1983 annual report have been used as the basis for determining revenue requirements. Willow Creek proposed adjustments to revenue and expenses as reflected in the comparative income statement filed in Part II of the application. The Commission is of the opinion that the proposed adjustments are generally proper and acceptable for rate-making purposes with the following modifications to reflect actual and anticipated operating conditions:

Normalized Revenue

The annual report filed by Willow Creek for the test year reflected 302 customers and operating revenues in the amount of \$38,620.

In response to an information request, Willow Creek filed information showing that the actual number of customers served at the end of the test year was 320. Therefore, the Commission has increased operating revenue by \$2,303 to reflect normalized annual revenue based on the number of customers at test year end.

Electricity Expense

Willow Creek proposed an adjustment to increase test-year electricity expense to \$11,738 based on increased rates by its supplier, Louisville Gas & Electric Company ("LG&E"). At the Commission's request, Willow Creek provided copies of its test-year electricity bills for examination.¹ No evidence was presented by Willow Creek that any of the increased cost was a result of increases in electric usage above actual test period amounts. Therefore, the Commission has determined, by applying actual test-year electric usage to currently effective LG&E rates, that electricity expense should be adjusted to reflect an annual expense of \$11,048.

Other-Labor, Materials and Expenses

Willow Creek reported test year charges to Account No. 701-C--Treatment System: Other-Labor, Materials and Expenses of \$1,690. However, subsequently, in response to a request by the AG, Willow Creek stated that because \$430 had been accrued in error by its accounting firm, \$1,260 is actually the correct level

¹ Response to Commission's Information Request dated August 15, 1984, Item No. 1(c).

of expense incurred during the test year.² Therefore, the Commission has reduced operating expenses by \$430 to reflect this modification.

Insurance Expense

Willow Creek reported test-year insurance expense of \$502. In support of this amount, Willow Creek filed statements for test-year insurance premiums.³ These statements reflect that \$132 of the charges to test-year insurance expense represents a pro-rata allocation of a \$4,620 annual premium for a life insurance policy on Mr. Carroll Cogan, owner of Willow Creek. The evidence of record in this case does not reflect the named beneficiary of this life insurance policy. Moreover, no evidence has been presented as to any benefit to the ratepayers of Willow Creek resulting from this insurance coverage. The expense charged to Willow Creek is based on a percentage of the total insurance premium equal to the ratio of total sewer connections of Willow Creek to total sewer connections owned by Mr. Cogan. Therefore, the amount charged to Willow Creek is based on an arbitrary allocation method and, moreover, Willow Creek has not met its burden of proof in establishing that the \$132 expense is a legitimate cost of operating Willow Creek. Furthermore, if Willow Creek is named as a beneficiary of this policy, under the Uniform System of Accounts for Class C and D Sewer Utilities ("Uniform System of Accounts")

² Response to AG's Data Request dated August 15, 1984, Item No. 1(h).

³ Response to Commission's Information Request dated October 17, 1984, Item No. 4.

the expense should be classified to Account No. 426--Miscellaneous Deductions, which is an expense chargeable to the stockholders and not the ratepayers. The Commission therefore finds that this policy is of no benefit to the customers of Willow Creek and should not be included as an operating expense for rate-making purposes. Therefore, insurance expense has been reduced by \$132.

Routine Maintenance

Willow Creek reported routine maintenance service expense of \$6,784 and proposed no adjustment to this account. Since the contract for routine maintenance service is between mutually-owned companies, Willow Creek and Andriot-Davidson Service Company, Inc., ("Andriot-Davidson"), the transaction is, by definition, at less than arms-length. Therefore, the burden of proof is on Willow Creek to demonstrate that the monthly charge for routine maintenance service is fair, just and reasonable, and to justify the basis for increasing the level of this fee from the amount found reasonable in Case No. 7932, Application of Willow Utilities, Inc., for an Order Adjusting the Rates Currently Charged by Willow Creek Sewer System, as reflected in the Commission's Order dated February 11, 1981. Willow Creek was put on notice to this effect and the Commission requested information necessary to make a decision on this matter; however, Willow Creek provided incomplete responses to the requests.⁴

⁴ ibid., Item No. 8.

In support of the fee charged by Andriot-Davidson, Willow Creek provided bids from several sewer operators proposing to provide routine maintenance service;⁵ however, the bids provided did not contain sufficient detail as to what services were to be provided by the several operators. Therefore, a comparison of the prices could not be made. Presumably as further support, Willow Creek provided a list showing hourly mechanic's labor charges at several car dealerships.⁶ However, this information is basically irrelevant and no evidence was provided as to why the Commission should consider the wages of auto mechanics when determining the reasonableness of transactions between the two mutually-owned companies or the fees for maintenance of sewage treatment plants.

It is the Commission's opinion that Willow Creek has not met its burden of proof as to why the routine maintenance fee paid to Andriot-Davidson is reasonable. Therefore, the Commission has made an adjustment to reduce the reported test-year routine maintenance expense to \$5,100, which was the fee allowed in Willow Creek's last rate case. In making this adjustment, the Commission does not find the allowed fee of \$5,100 a reasonable expense (further reductions could be necessary), but is merely establishing a point of reference based on what was allowed in Willow Creek's last case. The Commission will not allow further increases in transactions with this affiliated company without persuasive justification.

⁵ Ibid.

⁶ Ibid.

Transportation Expense

Included within Willow Creek's test-year operation and maintenance expenses are transportation charges in the amount of \$826. In support of this amount, Willow Creek provided a single, undated invoice from Carroll Cogan Companies, Inc., ("CCC") for \$686.⁷ The invoice listed charges of \$560 for 16 trips to the plant at \$35 per trip, and \$126 for other travel based on \$.25 per mile.

Because Willow Creek and CCC are mutually-owned companies, the transaction for car rental between CCC and Willow Creek is a less-than-arms-length transaction. Mr. Cogan, owner of both Willow Creek and CCC and also Barbour Manor Utilities, Inc., was put on notice in the final Order of Case No. 8933, Joint Application of Barbour Manor Disposal Plant, Inc. and Barbour Manor Utilities, Inc. for Approval of Sale and Transfer of Assets and Increase in Rates, that persuasive documentation of travel expense actually benefiting the customers of the utility would be necessary for a transportation expense to be included for rate-making purposes in future cases and that arbitrary allocation methods or insufficiently documented travel expenses would not be allowed. The burden of proof is on Willow Creek to establish justification and a sound basis for the expense. In this proceeding, no documentation of legitimate travel expenses benefiting the customers of Willow Creek has been provided.

7 Ibid., Item No. 9.

Reasonable expenses have been allowed in this proceeding for outside service companies to maintain the plant on a routine and non-routine basis. Substantially all transportation to and from Willow Creek for routine maintenance, sludge hauling, non-routine maintenance, etc., is provided for, either within a routine monthly fee or billed by vendors on a per-mile basis. No basis as to the necessity or purpose of the additional travel by Mr. Cogan has been provided. Additionally, whereas a personal service contract between Willow Creek and Mr. Cogan provides for reimbursement for travel, the Commission has established as a precedent in many cases, and included in this case, the allowance for managers of sewer utilities of this size, annual compensation of \$1,800, which includes ordinary travel requirements. Additional compensation, such as for travel from the utility offices or premises of the plant for outside business meetings, etc., must be sufficiently documented and justified.

As no persuasive evidence was presented in this case justifying the additional compensation, it is the Commission's finding that Willow Creek has not met its burden of proof on this issue and it has therefore eliminated reported test-year transportation expense from operating expenses for rate-making purposes.

Acquisition Adjustment, Depreciation Expense, Interest Expense

On February 11, 1981, the Commission approved the purchase of the sewage treatment plant and system serving Willow Creek Subdivision in Oldham County, Kentucky, by Willow Creek from Pence Mortgage Company ("PMC") for a price of \$27,500. The Uniform

System of Accounts requires the sale and transfer of a sewer utility to be recorded as follows:

1. Recording the utility plant acquired at its original cost to the person first devoting it to public service, estimated if not known, in the appropriate utility plant in service accounts;

2. Crediting the requirements for accumulated provision for depreciation and amortization applicable to the original cost of the properties acquired to the appropriate account for accumulated provision for depreciation and amortization;

3. Transferring the cost of any nonutility property to Account No. 121--Nonutility Property;

4. Crediting contributions in aid of construction to Account No. 271--Contributions in Aid of Construction; and,

5. Including in Account No. 108--Utility Plant Acquisition Adjustment, any difference between the purchase price and the original cost of the utility plant and nonutility property less the amounts credited to accumulated depreciation and amortization reserves and contributions in aid of construction.

Willow Creek failed to record the transaction within those guidelines. Willow Creek incorrectly recorded the transfer by debiting Account Nos. 101-109--Utility Plant and crediting Account No. 224--Long-Term Debt by \$27,500. Subsequently, Willow Creek began charging off the utility plant balance to depreciation. The 1983 Annual Report reflects that the \$27,500 incorrectly charged to utility plant as a result of the transfer is being depreciated

at a 10 percent annual rate;⁸ therefore, the test-year depreciation expense reflected on the books of Willow Creek associated with the purchase price of Willow Creek is \$2,750. As the Uniform System of Accounts makes no provision for the method used by Willow Creek to record the utility plant at the purchase price, the depreciation expense recorded for the test year is improper, without basis, in violation of the guidelines established by the Uniform System of Accounts, and unacceptable for financial reporting purposes as well as for rate-making purposes. Accordingly, the Commission has reduced depreciation expense by \$2,750.

In order to evaluate the rate-making implications if the sale and transfer had been recorded in accordance with the Uniform System of Accounts, the Commission has attempted to establish in this proceeding the correct information needed to properly record the transfer. In attempting to achieve this objective, the Commission requested information as to the original cost of the plant, requirements for accumulated provision for depreciation, and the proper amount of contributions in aid of construction in order to determine if an acquisition adjustment should have been recorded at the time of the sale and transfer and, if so, whether any portion of the amortization of the acquisition adjustment should be allowed for rate-making purposes. Willow Creek did not file complete responses to requests for information regarding the original cost of the plant and therefore, a determination cannot

⁸ 1983 Annual Report, p. 5, line 25.

be made regarding the appropriate cost which should be included on the books.

The Uniform System of Accounts provides for the recording of plant purchased at its estimated original cost when the required records are not available to ascertain the actual original cost. In Mr. Cogan's response to inquiries regarding the original cost, the figure of \$700,000 was quoted; however, no documentation as to how this estimate was arrived at was provided. The Commission cannot accept these undocumented estimates for accounting or rate-making purposes. Regardless of the appropriate value of the plant in service, Mr. Cogan has not provided any persuasive evidence that the plant was not fully contributed prior to the purchase by Mr. Cogan. The former owners of the sewer utility reported no plant in service. Furthermore, there was no debt on the books of the previous owners. This treatment of the assets by the previous owners is persuasive evidence that the owners had no investment in the sewer system that had not been recovered. Since the previous owners of the sewer utility had no investment that had not been recovered, the purchase of the utility by Mr. Cogan for \$27,500 constituted a purchase at a price in excess of net book cost which requires the recording of a plant acquisition adjustment.

Based on the evidence of record in this case the appropriate plant acquisition adjustment should be \$27,500. However, if the original cost of the plant, accumulated depreciation at the time of sale, and contributions in aid of construction are established and documented to the Commission's satisfaction, the plant

acquisition adjustment can be modified accordingly. Willow Creek should attempt to establish the proper values for the original cost of plant and seek Commission approval of the appropriate entries in order to comply with the Uniform System of Accounts.

It is dependent on the circumstances of the case as to whether this amortization expense is an appropriate expense for rate-making purposes. The Commission specifically placed Willow Creek on notice of its intentions in regard to the acquisition adjustment and requested Willow Creek to provide evidence it deemed appropriate as to,

why the Commission should not treat the cost of purchasing the utility as an acquisition adjustment and apply its established policy of disallowing the amortization of the acquisition adjustment.

Willow Creek responded with statements not directly related to the issue and did not provide evidence as to the appropriateness of allowing the acquisition adjustment in this instance. It is the Commission's opinion that it is unfair to require the ratepayers to provide additional monies on utility plant simply because it has been sold at a cost above book value. Allowing acquisition adjustments could result in the transference of property in order to increase its value for rate-making purposes. However, whether the amortization of an acquisition adjustment should be allowed must be determined on the merits of the evidence supporting the arguments in that particular case. The Commission must examine

⁹ Commission's Information Request dated October 17, 1984.

the facts and circumstances concerning a proposed acquisition adjustment. It may disallow the entire amount, or it may determine, based on substantial service improvements, operating efficiencies and the like, that a portion or all of the adjustment should be allowed. The record must demonstrate that the consumers are benefited by the acquisition. In this instance, Willow Creek has provided no evidence as to how the ratepayers benefited from the sale and transfer. In most circumstances involving the sale and transfer of a sewer utility there is little opportunity to substantially improve service. Commission statutes require a high standard of service to be provided by sewer utilities and local authorities monitor them closely as well. In this case, as concerns the day-to-day operations of Willow Creek, the Commission does not see how there could possibly be any benefits resulting from the sale and transfer. Both before and after the transfer a third party, Andriot-Davidson, was responsible for the day-to-day operations of the plant and the billing was being done by Louisville Water Company. This being the case, the ratepayers of Willow Creek would have scarcely noticed the change of ownership. The evidence of record in this case is insufficient to allow the amortization of the acquisition adjustment. The Commission has therefore excluded this expense for rate-making purposes herein.

Willow Creek reported test year interest on long-term debt of \$2,319. This amount represents interest charges on the \$27,500 used to finance the purchase of Willow Creek from PMC. As this debt is merely a result of the transfer of ownership of the treatment plant, as previously discussed, there are no benefits to the

ratepayers associated with the debt. Had the transfer not occurred there would not be any interest expense recordable on the books of Willow Creek. The Commission will not permit the new owner of Willow Creek to shift the finance charges associated with acquiring Willow Creek to the ratepayers without persuasive evidence that there are tangible benefits occurring to the ratepayers as a result of the transfer. As no such evidence has been presented, the proposed interest expense has not been included for rate-making purposes herein.

The Commission recognizes that some depreciation and interest expense was allowed in its final Order of Case No. 7932 dated February 11, 1981; however, the Commission is of the opinion that the evidence of record in this proceeding is sufficient to modify the decision in Case No. 7932.

After consideration of the aforementioned adjustments, the Commission finds Willow Creek's adjusted test period operations to be as follows:

	<u>Actual Test Period</u>	<u>Pro Forma Adjustments</u>	<u>Adjusted Test Period</u>
Operating Revenues	\$38,620	\$ 2,314	\$40,934
Operating Expenses	35,328	<5,416>	29,912
Operating Income	\$ 3,292	\$ 7,730	\$11,022
Other Income	-0-	-0-	-0-
Other Deductions	2,371	<2,319>	52
	<u>\$ 921</u>	<u>\$10,049</u>	<u>\$10,970</u>

REVENUE REQUIREMENTS

Willow Creek based its requested increase in revenue on an operating ratio methodology and requested revenue sufficient to produce a ratio of .88. In this case the Commission finds that an

operating ratio of 88 percent is fair, just and reasonable and will allow Willow Creek to pay its operating expense, service its debt, and provide a reasonable return to its owners.

In this instance the use of an 88 percent after-tax operating ratio applied to the adjusted test-year operating expenses results in a revenue requirement of \$35,202 which is less than the actual test period revenues. Therefore, the Commission finds that no deficiency exists in the revenues of Willow Creek and has, therefore, allowed no increase in revenues.

SUMMARY

On January 14, 1985, Willow Creek submitted notice to the Commission of its intent to begin charging the rates advertised in its original application as of February 6, 1985. In its Order of February 6, 1985, the Commission ordered Willow Creek to maintain its records in such manner as will enable it, or the Commission, or any of its customers, to determine the amounts to be refunded and to whom due in the event a refund is ordered upon final determination of this case in accordance with 807 KAR 5:076, Section 8.

The Commission, after consideration of the evidence of record and being advised, is of the opinion and finds that the rate proposed by Willow Creek should be denied. Furthermore, the rate charged by Willow Creek on and after February 6, 1985, is in excess of the rate approved herein and, therefore, the difference should be refunded to the appropriate customers.

IT IS THEREFORE ORDERED that the proposed rate in Willow Creek's application be and it hereby is denied.

IT IS FURTHER ORDERED that the rate currently charged by Willow Creek shall remain in effect.

IT IS FURTHER ORDERED that the revenues collected by Willow Creek subsequent to February 6, 1985, through rates in excess of those found reasonable herein shall be refunded in the first billing after the date of this Order.

IT IS FURTHER ORDERED that Willow Creek shall file a statement within 30 days of the date of this Order reflecting the number of customers billed, and the amount collected under the rate put into effect on February 6, 1985, the number of customers receiving a refund, the amount refunded and the date of the refund.

Done at Frankfort, Kentucky, this 22nd day of February, 1985.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:

Secretary